

# Chapter 9 - Acquisitive Corporate Reorganizations

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Concept of a “corporate reorganization” - the exchange of an equity interest in the old corporation for shares in the new corporation.

Cf., §1001 re possible gain recognition.

Effects of tax-free corporate reorganizations on:

- 1) Corporate parties to the transaction - no gain or loss on transfers of corporate owned properties.
- 2) Exchanging shareholders - no gain or loss.
- 3) Tax attributes - transferred to the acquirer.

# Reorganization Alternatives


p.395

The “concept” of a “corporate reorganization” for federal income tax (not bankruptcy) purposes:

- 1) Acquisitive reorganizations – one corporation acquires the stock or assets of another corporation (i.e., the “target”). Includes “A” (mergers), “B” (stock for stock) and “C” (stock for asset) deals, including various triangular reorg. transactions.
- 2) Divisive reorg. – splitting one entity into parts.
- 3) Nonacquisitive, nondivisive reorg. – restructuring of one corporation.

# Judicial Limitations - Tax “Common Law”

p.396

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- 1) “Business purpose” doctrine.
  - 2) Continuity of interest (COI) (or ownership) requirement – possibly in the definition of the reorg. (e.g., B reorg – stock for only voting stock).
  - 3) Continuity of business enterprise (COBE) requirement – applies to target’s business.
- Note: a “step” or “integrated” transaction rule or an “old and cold” rule also often applies.

# Concepts of Tax-free Corporate Reorganizations

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- 1) A limit is imposed on the character of the consideration received, i.e., a proprietary interest in the acquirer. Must be stock in the acquirer (cf., nonqualified preferred is not permitted).
- 2) Substantially all the transferor's properties must be acquired, i.e., the operating “business” must be acquired by “Purchaser.”
- 3) A business purpose (i.e., non-tax objective) for the transaction must exist.

# **Tax Code Provisions re Tax-free Reorgs p.396**

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§354 - no gain or loss is to be recognized upon an exchange of shares by those shareholders who are parties to a reorganization. Cf., §351.

§361 - no gain or loss to the acquired corporation. Also, §1032 for the stock issuance by acquirer.

§§356/357 - treatment of boot received and liabilities assumed in the transaction.

§358/362(b) - substitute tax basis rules.

§381 - carryover of tax attributes.

# How Assure Tax-free P.397 Reorganization Treatment?

## Options:

- 1) IRS Private Letter Ruling (PLR) – but, limited availability, unless a “significant issue” exists.
  - See Rev. Proc. 2019-3 re (non) ruling guidelines.
  - See Rev. Proc. 77-37 (e.g., p. 403) for guidelines for issuing corporate reorganization IRS private letter rulings. Is this Rev. Proc. “substantive law”?
- 2) Law firm or accounting firm tax opinion letter?

Increasing reliance on this approach (but what about large deals?).

# Statutory Merger or Consolidation

p.398

Code §368(a)(1)(A).

1) Merger: Shareholders of the target corporation receive shares of the acquiring corporation as a result of a “statutory merger” of target into purchaser (i.e., accomplished under a local law merger statute or foreign country merger statutes).

2) Consolidation: concurrent mergers of two existing corporations into a third (often new) corporation.

# Acquisitive Reorganizations

**p.396**

## Non-tax considerations:

- 1) Shareholder approval is required (dependent upon state law requirements). Both Target & Purchaser shareholders? How avoid Purchaser shareholder participation? (a) Low threshold acquisition (i.e., ordinary course of business), or (b) use of an acquisition subsidiary?
- 2) A dissenting shareholders' proceeding is possible to protest the consideration amount paid in the transaction to the Target shareholders.



# Divisive Mergers (i.e., not “acquisitive”)

p.399

Rev. Rul. 2000-5 – for tax-free corporate reorganization treatment the merger must be acquisitive, rather than divisive.

Mere compliance with the local (e.g., Texas) corporate law merger statute (i.e., calling the transaction a “merger”) does not constitute a merger transaction as a Code §368 tax-free corporate reorganization.

# **Mergers involving Disregarded Entities p.399**

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**Examples of mergers between (1) a corporation and (2) a disregarded entity:**

- 1) Merger of a target corporation into a disregarded entity (e.g., LLC of a corp.) is treated as a “merger” into another corporation. Why?**
- 2) Merger of an LLC into a corporation does not qualify - since only the divisional (i.e., LLC) assets are transferred & presumably not all the assets of the transferor corp. (i.e., the owner of the LLC).**

# **“Continuity of Proprietary Interest” – A Quantity Test**

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Southwest Natural Gas Co.

p.400

Merger of Peoples Gas into Southwest.

Less than 1% of the total consideration received was paid in the acquirer's common stock (i.e., \$5,592.50 stock and the remaining portion - \$587,000 - paid in bonds or cash).

Held: No “continuity of interest” results.

The stock received was not for a substantial part of the property transferred.

## 50% of Consideration as Stock

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Four 25 percent shareholders - A & B received cash for their 25% interests; C & D received stock for their 25% interests.

Held: COI requirement was satisfied when stock for at least 50% of the total value was issued.

Alternative: COI requirement is satisfied if each shareholder received 1/2 cash and 1/2 stock. A total of 50% of the consideration for the acquisition is in the form of stock.

# **What Stock Percentage is Required?**

## **P.403-4**

1) Nelson case (Sup. Ct – 1935) – 38% nonvoting preferred stock was OK for COI rule.

2) To obtain an IRS PLR – Rev. Proc. 77-37 requires a 50% stock value issuance.

3) Reg. §1.368-1(e)(2)(v), Ex.1 (40% ok); fn. 44.

What is large firm practice (the “New York rule”) re a tax-free merger opinion?

What is “stock”? Cf., “nonqualified preferred stock” (as constituting “boot”).

# **Other Continuity of Interest Issues:**

## **p.404**

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### **Remote continuity**

- 1) Can assets be dropped down into subsidiaries by the Acquirer and not violate COI test? Yes, if to controlled (80%) subs.**
- 2) Successive transfers permitted - to controlled subs and controlled partnerships.**

# Other Continuity of Interest Issues, cont. p. 405

- 2) When to measure the COI test compliance (to avoid possibly violating the COI threshold)?
- Day before the binding contract if a fixed number of shares is to be delivered (“signing date rule”).
  - Alternative if variable consideration, i.e., shares are increased if the Acquirer’s share value declines.
- See Rev. Proc. 2018-12 – use of average trading prices over, e.g., 5 to 35 trading days.

# **J.E. Seagram Corp. case**

## **Reorg. Treatment fn.60, p.406**

Competing tender offers for Conoco between Seagram and DuPont. Neither gets 50%.

DuPont then acquires the remaining Conoco shares for DuPont stock (including the 32% Conoco shares held by Seagram from prior cash purchase).

Seagram claims a loss (i.e., no reorg.) - but IRS was successful in asserting that this was a reorganization (i.e., continuity of interest did exist).

Pre-deal stock trading not negating the tax-free status of the Seagram-DuPont exchange.



# Continuity of Interest (COL) Regulations p.406

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Reg. § 1.368-1(e)(1)(i).

Disposition of stock prior to a reorganization to unrelated persons will be disregarded and will not affect the continuity of interest in the acquirer by the exchanging party.

Requirement: Exchange Target stock for Purchaser stock & have at least 50 percent of the entire consideration being received for the Purchaser's equity.

# **Post-Acquisition Continuity**

## **p. 407**

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**How long must the target shareholders hold their stock in the acquiring corporation after their acquisition?**

**What is the impact of a pre-arranged stock sale commitment by the majority shareholders?**

**The COI regulations focus on exchanges between target shareholders and the purchaser corp.**

**Sales of stock by former target shareholders are generally disregarded (unless made to P or sub).**

## Open Market Repurchase

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Reorganization acquisition (50/50 stock & cash), followed by open market reacquisitions of the Purchaser's stock (redemptions? § 302(b)(1)).

The purpose of the reacquisition was to prevent stock ownership dilution for the Purchaser.

No understanding that the P share ownership by the T shareholders would be transitory.

No impact on the COI status resulted.

Disposition of stock to unrelated persons is OK.

# Continuity by Historic Target Shareholders

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Kass v. Commissioner p. 411, note 75.

Squeeze-out upstream merger after a cash stock acquisition in a tender offer and a prior 80% plus purchase of Target's stock.

5.82 percent of the outstanding stock was not tendered but then subjected to a squeeze-out merger. This enabled acquisition of entire business.

Held: Not a merger - even though the shareholder received exclusively shares of the Acquirer.

# Continuity of Business Enterprise (COBE) p.411

Bentsen v. Phinney Corporation was engaged in land development business and transferred its property to a life insurance company.

Shareholders received stock of the insurance co.

Type of business carried on by the survivor entity (acquirer) was insurance (not property) business.

No IRS private letter ruling re tax-free status.

Held: COBE requirement was satisfied - need not engage in the same business – only some business activity. Appropriate result in this tax refund suit?

**Rev. Rul. 81-25**

**p.415**

**Transferor Business Important**

**COBE requirement – per IRS:**

**Look to the business assets of the transferor corporation (not the transferee corporation) to determine whether the continuity of business enterprise (COBE) test is satisfied in the acquisition transaction.**

**Reg. § 1.368-1(d) (1980).**

**Must look to the transferor's historic business; no relevance of the COBE requirement to the business of the Acquirer.**

# Continuity of Business Enterprise Regulations

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COBE regulations - Reg. §1.368-1(d). P. 415

COBE requires that the issuing corporation either  
(1) to continue the Target's historic business or  
(2) to use a significant portion of the Target's  
historic business assets.

COBE requirement is not violated if P transfers  
acquired T assets or stock to (1) controlled  
subsidiaries, or (2) a controlled partnership.

Reg. §1.368-1(d)(4).

# The “B” Reorganization - Stock-for-stock Exchange

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P. 416. Code §368(a)(1)(B).

Stock-for stock exchange (transaction is completed at the Target shareholder level):

Step 1. A stock exchange occurs between the Target’s shareholders and the “Purchaser” Corporation (for P Shares).

Step 2. The acquired Target Corporation then becomes a subsidiary of the Purchaser as a result of this stock acquisition/exchange transaction.



# Chapman case p.416, fn.83 ITT/Hartford “No boot in a B”

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Motion for Summary Judgment:

ITT as the Purchaser of Hartford – (1) acquires 8% for cash and (2) later an 80%+ exchange of “stock for stock” occurs.

Held: Cannot exclude the prior acquisition for cash - if any linkage exists. The 8% is not essentially irrelevant. The entire payment in the acquisition transaction must not contain any non-stock consideration. On remand a fact question: were the two transactions linked?

# What is “voting stock”

## p. 416

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Stock must provide an unconditional right to vote on regular corporate decisions (not merely in supermajority situations, e.g., acquisitions).

Stock can be (a) voting common stock or (b) voting preferred stock.

Warrants to purchase common voting stock do not themselves constitute voting stock for this purpose.

# Fractional Shares & Expenses

p.417

No cash is permitted in the B reorg. deal.

But, what if acquiring corporation buys back fractional shares. Invalidating the B reorg. status?

What income tax treatment to the (redeeming) shareholder? Redemption transaction with the acquiring corporation? Or, dividend treatment?

Payment of target corporation expenses – OK if the acquirer pays, but not if paying for expenses of the target shareholders. See Rev. Rul. 73-54, p.417.

# B Reorg. Eligibility & Dealing with Dissenters

P.417. Acquiring corporation pays cash to dissenters – this violates the “no boot in a B” requirement.

- 1) Target can redeem dissenters prior to the closing of acquisition deal (cash borrowed from Acquirer? – not permitted).
- 2) Redeem the dissenters after the acquisition deal is completed – but, will the dissenters agree? Is cash for dissenters part of the original deal?
- 3) Do not cash out the dissenters. Fiduciary duty to the minority (under corporate law)?

# Contingent Payments in a B Reorg.? P.418

Issue: Is the “stock only” requirement violated?

Options for delayed payment arrangements:

1) Commitment (only) for contingent consideration, i.e., actual shares are to be issued subsequently when specified criteria are satisfied.

2) Additional shares are escrowed – requires both (a) the payment of dividends, and (b) voting rights to the shareholders who might eventually receive the stock from the escrow fund. Why create an escrow?

# **“B” Reorganizations- Contingent Stock p.418**

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Contingent stock arrangements are acceptable to IRS (for B reorg. eligibility treatment) when:

- 1) Only additional (voting) stock can be issued.
- 2) A five year limit is applicable.
- 3) Valid business reason, e.g., a valuation issue.
- 4) Maximum 50% of the deal limit applies.
- 5) Contingent rights are not transferable.
- 6) No control by the seller of the triggering event.

# The “C” Reorganization - The “Practical Merger”



P.419. Criteria for a valid "C" reorganization:

- 1) Voting stock of the Acquirer is received by the Target corporation.
- 2) “Substantially all” the properties are transferred.
- 3) Liquidation of the Target with the distribution to the T shareholders of the Acquirer’s stock received.
- 4) Assumption of some liabilities is permitted.
- 5) Limited "boot" exception - but a 20% limitation rule (including for the liabilities assumed) applies.

# The “Substantially All” Requirement

## p.420

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What is “substantially all” of the property?

IRS ruling position: 70% of the gross & 90% of net assets (for ruling purposes) are to be acquired.

Emphasis on the “operating assets” (even if the percentage tests are not met).

Cannot be a divisive transaction; but, consider Rev. Rul. 88-48 (p. 420, fn. 102) permitting the sale of 50% of the historic assets if the cash proceeds are also transferred by Target corporation to Purchaser.



# Liquidation of the Target Corporation

p.420

§368(a)(2)(G) requires the Target to distribute all its assets (including the shares of the purchaser corporation) in liquidation of Target.

Possible waiver of the liquidation requirement can be obtained from the Service. When? If so, treated as if (a) the distribution to Target shareholders had actually occurred, and (b) the assets were thereafter contributed into the capital of a new corporation.

# Creeping Acquisitions

## p.421

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Prior purchase of stock of the Target - is this purchase transaction “old and cold”?

Purchaser’s prior holding of stock does not invalidate the “solely for voting stock” requirement. See the prior *Bausch & Lomb* history.

Under the “boot relaxation” rule the non-qualifying consideration cannot exceed 20% of the value of all of the Target’s properties.

Reg. § 1.368-2(d)(4)(i) & (ii).

## **“C”, not a “B” Reorganization**

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1) Y corporation acquired X corp. shares from X corporation shareholders in exchange for Y stock. Is this a “B” reorganization?

2) But, X Corp. was then liquidated into Y Corp. & Y then conducted the X business.

Held: A “step transaction” analysis applies: not a “B” reorganization, but a “C” reorganization, i.e., a “stock for assets” exchange.

Why differentiate between the “B” and “C”?

# Objectives of Triangular Reorganizations p.423

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To satisfy business (i.e., non-tax) objectives.

- Parent avoids hidden liabilities in the transferred assets (through the isolation of the liabilities of the Target into a separate sub); but, cf., use of a D.E.
- To facilitate the acquisition of non-transferable assets (through maintaining the Target corporation's separate corporate existence).
- To avoid shareholder votes (parent corp. as the sole shareholder votes stock of the acquisition sub).

# Structures of Triangular Reorganizations p.423

*[See separate charts for the structuring of these triangular reorganization transactions].*

- 1) Drop-down of assets (merger) - §368(a)(2)(C).
- 2) Use of subsidiaries to complete acquisition –
  - “parenthetical B” - §368(a)(1)(B)
  - “parenthetical C” - §368(a)(1)(C)
- 3) Forward triangular merger - §368(a)(2)(D)
- 4) Reverse triangular merger - §368(a)(2)(E).

# **Forward Triangular Merger**

## **p.424**

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**Forward triangular merger - §368(a)(2)(D).**

**P creates Sub and contributes P stock to the Sub. Then, Target merges into the Sub.**

**Requirements:**

- Sub acquires “substantially all” of properties of T (note the C reorg. equivalency).**
- No Sub stock issued in the exchange transaction.**
- Would have qualified as an “A” reorg. (i.e., possible 50% cash?).**

# Reverse Triangular Merger

## p. 425

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Reverse triangular merger - §368(a)(2)(E).

Objective: retain the corporate status of Target.

P creates Sub and contributes P stock to Sub; then, Sub merges into target.

Requirements in the deal:

- 1) Target remains holding assets of Target and Sub.
- 2) Former Target shareholders receive P stock in exchange for their “control” of Target.

“B” reorg. equivalent? Limited boot is permitted.

# **Multi-Step Transactions Analyzed**

**p.426**

**Objectives in multi-step transactions:**

- 1) Achieve the business plan – including regulatory and financial accounting issues.**
- 2) Income tax result based on overall transaction.**
- 3) Relevance of Section 338/cash asset purchase transaction treatment.**

**Overall objective: (1) get assets & establish control position; (2) then, restructure entities to rationalize the business operations.**



# Multi-Step Transactions

Rev. Rul. 2001-26

p.427

§368(a)(2)(E) - reverse triangular merger issue:

Transaction: (1) tender offer of P stock for 51% of T's stock, followed by (2) merger of P's sub into T and remaining T shareholders receive P voting stock and cash combination (83%+ consideration is stock).

(Alternative: Sub initiates the tender offer).

Held: When segments are integrated at least 80% of the T stock was acquired for P stock & tax-free reorg. status is available (under §368(a)(2)(E)).

# Multi-Step Transactions

Rev. Rul. 2008-25

P.429

1) P forms merger sub which merges into T.

Consideration paid to T shareholder is 10x cash and 90x in P voting stock.

2) T then liquidates into P (not a merger) & then P conducts the T business.

If separate: §368(a)(2)(E) & then §332 liquidation.

If integrated: Not a §368(a)(2)(E) reorg since T does not hold substantially all properties.

Holding: not a reorg & gain to shareholder; but not a stock purchase without a §338 election.

# Problem 1(a)

p.437

## Stock & Notes Received

Transaction qualifies as a “Type A” reorganization. Nonvoting preferred stock (\$300,000) and 5 year notes (\$100,000) are received in merger of T into P. Therefore, 75% of the consideration received by T shareholders is P stock and the continuity of interest rule is satisfied. See Regs. - 40% test.

Gain nonrecognition to the shareholders - except to the extent that they receive “boot” (notes) - again assuming not “nonqualified preferred” stock.

# Problem 1(b)

p.437

## Stock & Notes Received

“Type A” reorganization. (1) Voting common stock (\$400,000) received by four shareholders (total 40%) and (2) cash (also \$400,000) received by six shareholders (total 60% cash) in merger.

Is the continuity of interest rule satisfied (& even if some receive only cash)? Yes. Rev. Rul. 66-224.

See Regs. re 40% test; 50% test - Rev. Proc. 77-37.

No gain recognition to the shareholders receiving only stock. §354. Taxation to the cash recipients.

# Problem 1(c)

p.437

## Stock Value Declines



Issue: When to measure continuity of interest?

Valued on last business day before contract becomes binding, if contract provides for fixed consideration.

Here total value of deal declines from \$4 million to \$3,400,000. Each of four shareholders lose 150x.

Stock is 1,000 of 3,400 or 29% of total consideration.

But, 40% stock consideration did exist when the deal became binding and the COI test is then deemed satisfied (under the “signing” date rule).

# Problem 1(d)

## Stock Sale of 60%

p.437

T merges directly into P and each T shareholder receives \$400,000 of P voting common stock.

Under a binding commitment six shareholders (with 60% of T stock) sell to a 3rd party post merger.

Rules now provide the COI test is satisfied *even if* disposition occurs per a pre-existing agreement.

Even OK if otherwise a COI problem since 40% stock is retained here.

Selling shareholders do have gain when selling.

# Problem 1(e)

p.437

## P sells T's assets; COBE?

P sells T's assets to unrelated party and the proceeds are used to expand P's business.

COBE issue: Was T's historic business continued?

Is being in same general line of business (publishing) sufficient to establish the requisite COBE?

Probably not here.

Of course, can not sell assets and, e.g., invest in a mutual fund. Then clearly not satisfying the COBE test.

# Problem 1(f)

p.437

## Exchange for Stock & Cash

P transfers to each T shareholder \$360x of voting preferred stock and \$40 cash for each T shareholder's shares in T. Shareholder level exchange occurs.

This is a stock-for-stock exchange requiring an analysis as to “B” reorg qualification.

But, no boot in a “B”; therefore, no tax-free reorganization treatment is available here. Full gain recognition is required as to all T shareholders.



# Problem 1(g)

p.437

## “B” Tax-free Exchange?

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P (a) purchases T shares from Dee Minimis for 400x and (b) shortly (?) thereafter P exchanges with each other T shareholder its P voting preferred stock (9 times 400x) for T shares. Is “step transaction” treatment applicable here?

If so, the first (cash) transaction disqualifies the rest of transaction from “B” reorg. treatment. If not?

Remember: No boot in a “B.”

Alternative: Redeem dissenter’s shares in advance.

# Problem 1(h)

p.437

## C Reorg - Asset Acquisition

P acquires T assets (\$5 mil.) and assumes T liabilities (1 mil.) for \$3.6 mil. of P voting stock to T shareholders, plus \$400x five year P notes.

Is “C” reorg treatment available? Substantially all assets are acquired. But, the consideration includes (a) 400x boot and (b) 1.0 mil debt assumption.

Thus, 72% (3.6x of 5.0x) of consideration is stock and 28% (1.40x of 5.0x) is received as cash & notes.

Not a “C” reorg. All shareholders are fully taxable on realized gain.

*continued*

# **Problem 1(h), cont.**

## **C Reorg - Asset Acquisition**

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**Drop-down by P to S, s newly created subsidiary.  
This drop-down does not raise a remote continuity issue.**

**But, here not a reorganization which would allow gain postponement.**

# Problem 1(i)

p.438

## Asset Acquisition

Same as 1(h); P acquires T assets (\$4.6 mil.), but not 400x cash and assumes T liabilities (1 mil.) for \$3.6 mil. P voting stock to T shareholders.

T distributes the P shares pro rata (and 400x cash).

“C” reorg treatment is available. The liability assumption is not treated as boot. And, the §368(a)(2)(G) distribution requirement is satisfied.

Were “substantially all properties” transferred?

Transfer of 92% of gross (4.6/5.0) and 90% of net (3.6 of 4.0). All operating assets were transferred.

# Problem 1(i) p.438

## Asset Acquisition, cont.

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What options, e.g., to avoid transfer of voting stock?

- a) Forward triangular merger – Target merges into P subsidiary, with Sub acquiring substantially all properties; 50% continuity is OK, & no voting stock is required.
- b) Reverse triangular merger (also to isolate liabilities to T); Therefore, T is preserved as an entity; but the consideration paid for T must be at least 80% for P's voting stock.

# Problem 2(a)

p.438

## Reverse Triangular Merger

P's sub Y-1 merges into T; four T shareholders each receive \$400x cash; six T shareholders each receive \$400x P nonvoting preferred stock.

T then merges upstream into P.

Multi-step acquisition & a step-up transaction.

First step – not a qualifying 368(a)(2)(E) (40% is too much cash) & a §338 qualified stock purchase.

But, if integrated (with an upstream merger) then treated as an “A” reorg. (i.e., as a single merger)?

Rev. Rul. 2001-46 (see Rev. Rul. 2008-25)?

# Problem 2(b)

p.438

## Reverse Triangular Plus

P's sub Y-1 merges into T; four T shareholders each receive \$400x cash; six T shareholders each receive \$400x P nonvoting preferred stock. But, T then merges into Y-2, a sub of P (avoiding liability).

1) A (failed) §368(a)(2)(E) merger followed by a sidewise merger of T into a different P subsidiary.

2) If integrated (Rev. Rul. 2001-46?), a §368(a)(2)(D) forward triangular merger; COI test is satisfied (60%), & “substantially all” properties test is met.

# Problem 2(c) p.438

## Reverse Triangular + ???

P's sub Y-1 merges into T; four T shareholders each receive \$400x cash; six T shareholders each receive \$400x P nonvoting preferred stock.

1) A (failed) §368(a)(2)(E) merger.

Followed by a liquidation of T into P (which is not a statutory merger, but §332 applies).

2) A failed “C” reorg (Rev. Rul. 2008-25) – since no voting stock issued. Not a Type A since no merger.

All shareholders recognize gain on the stock sale.



## Problem 2(d)

p.438

## Reverse Triangular Merger

P's sub Y-1 merges into T, but T is a wholly owned sub of S, Inc. Not a qualifying reverse triangular merger; but, an A reorg. if integrated with the subsequent upstream merger of T into P.

However, the first step is a qualified stock purchase for §338 purposes. Therefore, does the step transaction doctrine apply here? No, “turned off.”

Have the parties bargained for a taxable transaction when making the §338(h)(10) election? If a reorg. then no §338 election is permitted.

# Problem 3

p.438

## Creeping Acquisition Issue

10% stock purchase for cash five years ago is “old and cold.” Purchase of additional 50% - question as to whether this is part of a “step transaction.”

Will acquisition of remaining 40% enable reorganization treatment?

1) Type A Reorg. (e.g., statutory merger of T into P) – this would qualify even when 40% receive nonvoting preferred stock. Plus 10% old continuity. Not qualifying if large percentage earlier acquired for cash and only small % then squeezed-out.

# Problem 3

p.438

## Creeping Acquisition, cont.

2) Type B reorg? – qualifies if the 50% cash acquisition is not related to the final 40% acquisition & made for voting stock (and this portion qualifies for tax-free treatment).

3) Type C reorg? – P to acquire all T's assets in exchange for stock and liquidate, distributing voting stock to the 40% remaining shareholders. Yes, ok, if the prior 60% stock acquisitions “old and cold.”

# Acquisitive Reorgs - Treatment of Parties p.438

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Consider the income tax treatment resulting from a tax-free corporate reorganization for the following parties to that reorganization:

- 1) Shareholders of the Target corporation.
- 2) The Target corporation.
- 3) The Acquiring corporation (and any acquisition subsidiary).

# Shareholder Consequences in a Reorganization p.439

§354(a)(1) - no gain or loss is to be recognized on the share exchange (if solely for stock).

§358 - carryover/substituted stock basis.

§1223(1) - tacked holding period.

What if "boot" (cash or FMV of property) – then realize gain to the extent of the boot (& what tax character of the boot)?

Often received in other than a B reorg. §356(a).

Tax basis for any “boot” received – its FMV.

*continued*

# Shareholder Consequences for “Boot” (if any)? P.439

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- 1) Receipt of “excess securities” (principal amount of securities received exceeds principal amount transferred away) - the excess is treated as boot. See §356(a)(1).
- 2) Or, no prior securities held and receiving securities – also receiving boot. §356(a)(1) & §356(d).
- 3) If giving up securities and receiving stock (or a lesser amount of securities) no boot is received in this transaction (and no gain recognition, but also no loss recognition). Here shifting into equity.

# **Tax Characterization of Boot Gain?**

**p.440**

**§356(a)(2). Recognized gain is treated as a dividend if the exchange “has the effect of the distribution of a dividend.”**

**If such an effect has occurred, dividend treatment exists to the extent of the ratable share of the E&P treated as distributed (limited to the gain).**

**How determine this ratable share? See Clark case discussion, below.**

# Characterization of Boot as Dividend or Capital Gain

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A “boot dividend” is limited to the gain amount.

§356(a)(2) - (i.e., “dividend within gain”)

Tax rate of 20% on both dividend and capital gain reduces the tax significance, but:

- 1) Preferring dividends & thus dividends received deduction (DRD) – for a corporate shareholder?
- 2) Boot gain if received in form of installment notes?  
– no deferral if dividend characterization applies.



# **Commissioner v. Clark**

## **p. 440 (n.134) Code §356(a)(2)**

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Code §368(a)(2)(D) reorganization.

Received 300,000 P shares and \$3.25 mil. cash. But, could have received 425,000 P shares.

How determine Code §356(a)(2) applicability?

- 1) A deemed pre-reorganization redemption of the Target acquired shares (Shimberg -5<sup>th</sup> Cir. ); or,
- 2) A deemed post-reorganization redemption of the acquiring corp. (P) shares (Wright case)?

**Holding:** Test after the reorganization exchange.

# **Allocation of Consideration Received**

**p.441**

**Situation: Receipt of stock and boot for several blocks of stock held by the shareholder.**

- 1) Allocate boot to that stock with the highest tax basis (assuming no dividend effect)? Permitted.**
- 2) Pro-rata allocation required where boot has dividend effects.**

**Must the terms of the merger identify those shares to which the boot is to be allocated? Yes, see regs.**

# **Tax Basis for Target Shareholders**

**p.443**

§358 – basis in the stock received is derived from the basis of the stock transferred by target shareholder. What about multiple “tax lots” for shares received? – tracing or pro rata allocation? Allocation to each block of stock is required. Average basis method is not available – use tracing into the separate blocks. Cf., FIFO rule, Reg. §1.1012-1(c); & basis reporting by brokers – §6045(g) regs. (effective in 2011).

# Target Corporation p.445

## Consequences & Issues

Income tax realization events occurring:

1) Reorganization exchange of its property for stock (and boot) (e.g., “A”, “C” or forward triangular reorganization). §361(a). Not relevant for B reorg or reverse triangular merger.

2) Distribution in C reorg. corporate liquidation of the Purchaser’s stock received (or boot) (or the sale of that stock prior to corporate liquidation).

Any income recognition (for tax purposes) upon these events occurring? No - §361(c).

# **Reorg. Exchange P.445**

## **Target Level Treatment**

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**§357(a) - assumption of the target's liabilities is not treated as boot & does not stop tax-free treatment.**

**These rules apply to (1) “A” & “C” reorgs. and (2) forward triangular mergers. But, not for “B” reorganizations, or reverse triangular mergers, since stock exchange at shareholder levels & corporation is not directly affected. *Continued.***

# **Reorg. Exchange & Boot Target Corp. Treatment**



Receipt of (permitted) boot in a C reorganization:

- 1) Recognize any realized gain if the target does not distribute in the reorganization.
- 2) If distribution of the boot received does occur (see below) – then, no required recognition to distributing corporation.

§361(b)(1)(A) & (B).

# **Shareholder Distributions - Target's Tax Effects p.446**



No gain or loss is recognized to Target when it distributes “qualified property.” See §361(c).

“Qualified property” requirement is under §361(c) - stock of the other party in the reorganization, or promissory notes.

Includes transfers to creditors as being a nontaxable distribution for this purpose. §361(b)(3) & (c)(3)

If distribution is of other than “qualified property” - e.g., boot or a retained asset. Then, gain recognition on the distribution is required. §§361(c)(1) & (2).

# Target's Tax Effects p.446

## Sales Before Liquidation

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Sale of stock by Target (e.g., sale of stock received for funds to pay debt) is treated as generating gain. What is the Target's tax basis? See below.

However, direct transfers of “qualified property” or boot to creditors (to pay debts) will qualify for non-recognition as the equivalent of distributions to shareholders. See §361(b)(3) & (c)(3).



# Acquiring Corporation Consequences

p.447

§1032(a) - issuance of its shares in acquisitive reorg. by acquiring corporation is not a taxable event.

Same result if issuance of debt securities by the acquirer occurs. But, transferring other assets – any gain is to be recognized on transfer.

Tax basis for the assets received by Acquirer:

§362(b) carryover basis from the transferor.

This is relevant in acquisition of target's assets:

“A” or “C” & the forward triangular merger.

# Buyer Transfers Property

## Rev. Rul. 72-327, p.448, fn.

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- 1) Acquiring corporation using appreciated property for acquisition recognizes gain on use of that appreciated property (40x fmV less 10x basis equals 30x gain). *Davis* case.
  - 2) Acquirer's E&P is increased by the gain recognized.
  - 3) Acquirer succeeds to the Target's E&P.
- Continued (recipient's issues)*

# **Rev. Rul. 72-327, p.448, fn.172 (other issues)**

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- 1) Recipient corporate shareholder receiving dividend boot can obtain dividends received deduction (under §243(a)).
- 2) FMV basis for the asset received by shareholder as dividend boot.
- 3) Shareholder receiving realized gain is required to recognize that gain to extent of boot and (for corporate recipient) to include that boot amount in its E&P.

# **Acquiring Corporation Consequences - Stock Deal**

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**P. 448. What tax basis result to a Acquirer when receiving stock from the “seller” shareholders in exchange for Acquirer stock? In a "B" reorganization (or a reverse triangular merger) - take shareholders' tax bases for stock exchanged. Sampling is acceptable to determine the stock basis of the “selling” shareholders if Target has multiple shareholders. Rev. Proc. 81-70, as amplified by Rev. Proc. 2011-35, re using statistical analysis.**

# Acquiring Corporation - Triangular Reorganization

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What if issuance by the sub of parent corp.'s stock – does this constitute a transfer of appreciated property by the sub to the target shareholders? No.

What is the tax basis to the parent for the target stock received in a triangular reorganization (i.e., merger of (i) target into sub, or (ii) sub into target)?

Not the basis of the stock of subsidiary (often zero). Rather - treat as (i) an asset acquisition, and (ii) an asset drop down into sub. Reg. §1.358-6(c)(1)& (2).

# Problem 1(a)

p.450

## Merger “A” Reorganization

Each shareholder receives (1) 4,000 shares (\$40,000 FMV) of voting common stock and (2) nonvoting (not nonqualified) preferred stock worth \$10,000.

- 1) Nontaxable - solely “stock for stock.” §354(a).
- 2) Substituted basis. §358(a)(1) - \$20,000 total basis;  
Common - 16,000; preferred - 4,000
- 3) Tacked holding period. §1223(1).
- 4) Preferred stock & §306 stock. §306(c)(1)(B). Even if received in a merger? Yes. But, §306(b)(4)?

continued

# **Problem 1(a), cont. p.450**

## **Merger “A” Reorganization**

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Target’s merger into P – no gain on the transfer of Target’s assets in the merger. T’s e&p (and other tax attributes) go to Acquirer (P). §361(a) & §381(a).

Acquirer (P) takes assets with (1) a \$300,000 transferred basis and (2) a tacked holding period for those assets. §362(b) & 1223(2).

# Problem 1(b)

p.450

## Note & Not Stock Received

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Shareholder receives (1) 4,000 voting common stock plus (2) a 20 year \$10,000 interest bearing note (rather than the preferred stock).

\$10,000 gain is to be recognized as boot; effect of a dividend distribution? Necessitates a *Clark* case analysis re §302(b)(2) redemption status eligibility.

Treatment as if (1) each shareholder received 5,000 shares and (2) subsequently transformed his/her 1,000 shares into the \$10,000 note. *continued*



# Problem 1(b) *continued*

## Note & Stock Received

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- 1) Each shareholder before the deemed redemption:  
5,000 shares = \$50,000 (1,000 shares are “boot”).  
550,000 shares equals .909 shareholder percentage.
- 2) After redemption:  
4,000 (actual shares retained by each shareholder)  
540,000 equals .741 percent.
- 3) but, 80% times .909% equals .727% , and  
the §302(b)(2) test is not satisfied. But, is §302(b)(1)  
 (“not essentially equivalent”) test applicable?

# **Problem 1(b) *continued***

## **Note & Stock Received**

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T shareholders: If the gain is capital gain – possibility of deferral of gain recognition under installment sales rules (§453), unless the notes are issued for publically traded stock.

Results for Acquirer (P) and T: Same as Problem 1(a), except if the boot gain is a dividend, then reduction of E&P by \$100,000 to zero.

# Problem 1(c)

p.450

## Notes to Two Shareholders

Two shareholders receive notes - \$100,000.

The remaining shareholders receive voting common stock worth \$400,000.

1) Shareholders receiving solely voting stock:

Non-recognition under §354(a)(1). Tacked holding.

\$20,000 substituted basis under §358(a)(1).

2) Shareholders receiving solely securities. No §354.

Not boot, since no non-recognition property is received. Treated as §302 redemptions & §453.

# Problem 1(d)

p.450

## Boot & T has limited E&P

T had \$50,000 E&P, not \$100,000 E&P.

Assume boot is received as a dividend. §356(a)(2).

What is the amount of the §356(a)(2) dividend:

- 1) only \$50,000 of T's E&P? or,
- 2) also the E&P of acquiring corporation (cf., §304(b)(2) result)?

Assuming only T's E&P as relevant: Each shareholder has \$5,000 dividend & \$5,000 gain from stock sale. Note basis - \$10,000; stock basis - \$20,000.

# Problem 1(e)

p.451

## “C” Reorganization

P transfers its voting stock worth \$500,000 in exchange for T's assets (fmv \$600,000; basis 300,000), & \$100,000 debt; T distributes P shares.

- 1) P - no gain when issuing P stock - §1032. P takes T's E&P & T's assets with \$300,000 basis - §362(b).
- 2) T has no gain recognition for the \$300,000 realized gain - §361(a). No gain recognition to T on the liquidation distribution of the P stock - §361(c).
- 3) T's shareholders - nonrecognition (§354(a)), each has an exchanged basis (\$20,000) - §358(a)(1), & a tacked holding period (§1223(1)).

# Problem 1(f)

p.451

## Cash Used for Liabilities

P transfers \$500,000 of voting stock and \$100,000 cash to T; cash used to pay T debt. C reorg & boot. Stock is distributed in complete liquidation.

1) Target - recognizes no gain on the transfer of its assets to P - §361(a) & (b)(1)(A). “C” Reorg.

T received \$100,000 boot distributed to creditor & thus qualifies as a reorg. distribution. §361(b)(3).

Distribution: No T gain on distribution of P stock - all is “qualified property” - §361(c)(1). continued

# **Problem 1(f), continued**

## **Cash Used for Liabilities**

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2) Acquirer (P) - no recognition on its cash & stock transfers. §1032. P takes T's assets with transferred basis of \$300,000. P succeeds to T's E&P (under §381(a)(2)).

3) T shareholders: eligibility for non-recognition – §354(a). Under §358(a)(1) each shareholder takes a \$20,000 exchanged tax basis for new shares.

# Problem 1(g)

p.451

## Securities as “boot.”

P transfers to T (a) voting stock worth \$500,000 and (b) investment securities (basis \$40,000 and value \$100,000 ) for all T's assets not subject to any liabilities. T sells the securities and pays off liability, liquidates, and distributes P stock to shareholders.

1) T – no gain recognition on its asset transfers in exchange for stock & boot if T distributes boot. §361(b)(1)(A). But: \$100,000 gain recognized from undistributed securities. §361(b)(1)(B). No gain on boot sale for 100 basis. No gain recognition on the P stock distribution by T. §361(c)(1).

*continued*



# Problem 1(g), continued

## Securities as “boot.”

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2) P Corp – no gain on issuance of its stock - §1032.  
P is to recognize \$60,000 gain on its transfer of its appreciated investment securities – as “boot.”

P increases its e&p by the \$60,000 gain.

P takes T's assets with \$400,000 basis - \$300,000 transferred basis & \$100,000 gain recognized by T. §362(b). & taking T's E&P. §381(a)(2).

3) Shareholders - non-recognition (§354(a)) & exchanged basis (\$20,000) - §358(a)(1), & tacked holding period (§1223(1)).

# Problem 1(h)

p.451

## Stock Sold for Paying Debt

P transfers \$600,000 stock for T's assets and no assumption of T's debt. T sells \$100,000 of P's stock and pays T's debt. T distributes the remaining shares in the liquidation distribution.

1) T recognizes no gain on transfer of its operating assets. §361. If a direct transfer of stock to creditors, no recognition. §361(c)(3). No immunity for a sale and, therefore, \$50,000 gain is to be recognized (\$100,000 less \$50,000 – 1/6<sup>th</sup> of A shares 300 basis).

No gain on the distribution of the remaining stock.

# Problem 1(h), continued

## Stock Sold for Debt

2) P corporation – no gain on the issuance of its stock. §1032. P has a \$300,000 transferred basis in T's assets and P inherits T's E&P account (increased to \$150,000 by the \$50,000 gain on the stock sale).

No increase in basis of T's assets because of \$50,000 sales gain being recognized by T.

3) T shareholders - non-recognition (§354(a)) & exchanged basis (\$20,000) - §358(a)(1), & tacked holding period (§1223(1)).

# **Problem 1(i)**

**p.451**

## **T's Direct Stock Transfer**

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Transfer of P stock by T directly to creditors of P as part of the reorganization plan.

Code §361(c)(3) permits the non-recognition of gain (i.e., the \$50,000 is gain not recognized by T) in this transaction (& no E&P adjustment for T).

The stock transfer is treated as a distribution of “qualified property” to the shareholders, entitling T on this transfer to non-recognition under §361(c)(3).

# Problem 2(a)

p.451

## Forward Triangular Merger

§368(a)(2)(D) merger – forward triangular of P’s sub into T.

1) P forms S - no gain to P (§361(a)) on formation of S or the drop-down of the P shares into S.

P’s basis in its S stock (after the completion of the acquisition) is equal to T’s basis in T’s assets - \$100,000. Reg. §1.358-6(c)(1) (p. 450). Same as an “A” reorg. with a drop-down of assets into a sub.

*continued*

## Problem 2(a)

p.451

# Forward Triangular Merger

2) S - no gain on its issuance of its own stock. §1032.

S holds P stock with a zero basis. §362(b).

S has no gain on S's transfer by it of the (zero basis)

P stock it holds. S takes T's assets - \$100,000 basis.

3) T's shareholders - no gain recognition for P stock received & a \$50,000 substituted basis & a tacked holding period.

4) T – nonrecognition on the transfer of its assets & its deemed liquidation. §361(a) & (c)

# Problem 2(b)

p.451

## Reverse Triangular Merger

- §368(a)(2)(E). 1) Parent - non-recognition on the formation of S. P's subsequent basis in its S stock – is adjusted as if T had merged into S in a forward triangular merger. \$100,000 for assets after reorg.
- 2) S - No gain on S issuing its own stock (§1032) or when transferring (zero basis) P stock to T (§361).
- 3) T – nonrecognition (T stock for P stock). §354.
- 4) T shareholders – nonrecognition when receiving P stock for T stock. §354(a)(1) & 50x substituted basis.

# Problem 2(c)

p.451

## Forward Triangular Merger

Failed §368(a)(2)(D) – forward triangular merger.

1) Parent - non-recognition on §351 formation of S and issuance of its stock. Holds S stock with §358(a)(1) zero substituted basis.

2) S - No gain on issuing its own stock. §1032.

Then, \$200,000 gain (STCG) to S when transferring its zero basis P stock to T. S then has a \$200,000 §1012 basis for assets received from T and no E&P from T.

*continued*



# Problem 2(c)

p.451

## Forward Triangular Merger

Failed §368(a)(2)(D) – forward triangular merger.

3) T – has \$100,000 gain recognition on the transfer of its assets. T takes a \$200,000 cost basis for the P stock received.

4) T's shareholders recognize \$150,000 cap. gain on their exchanges of T stock for P stock (§331).

Shareholders have 200,000 fmV basis for their P stock held (§334(a)).

Planning answer: P issues its shares directly in an exchange with T shareholders (avoiding S).

# Problem 2(d)

p.451

## Reverse Triangular Merger

Failed §368(a)(2)(E).

1) Parent - non-recognition on the formation of S.

P holds S stock with a zero basis. §358(a)(1).

2) S - No gain on issuing its own stock. §1032.

S acquires the P stock with a zero basis. §362(a).

But, \$200,000 gain (STCG) when transferring P stock to T. S acquires the T stock with a \$200,000 cost basis. And, \$200,000 of E&P to S which then transfers to P.

*continued*

## Problem 2(d)

p.451

# Reverse Triangular Merger

Failed §368(a)(2)(E).

3) T transfers its T stock for P stock and T has no gain recognition - §1032.

4) T shareholders have a \$150,000 capital gain on their T stock upon the P stock exchange. They take a \$200,000 cost basis for their P stock.

Planning answer: P issues its P shares directly in an exchange with the T shareholders.

# **Tax Policy Issues**

## **P.451**



**Should the tax rules for mergers & share acquisitions be elective for shareholders - assuming cash is not received by the shareholders?**

**Should corporations be permitted to elect taxable or tax basis carryover status (assuming shareholder continuity), except where receiving boot type property (including cash)?**

**Should one uniform rule be adopted to prescribe the continuity of interest rules?**

